Part E. Tax Abuses--Mixed Business/Personal Use

Many expenses that involve significant personal consumption are currently being deducted as business expenses. This is unfair to taxpayers who do not have access to business perquisites and also distorts consumption choices. The proposals would limit deductions for entertainment, business meals, and travel expenses. In addition, rules are proposed to specify the circumstances under which taxpayers who have no regular place of work can deduct commuting expenses.

LIMIT DEDUCTION FOR ENTERTAINMENT AND BUSINESS MEAL EXPENSES

General Explanation

Chapter 3.22

Current Law

Ordinary and necessary expenses paid or incurred during a taxable year generally are deductible if the expenses bear a reasonable and proximate relation to the taxpayer's trade or business or to activities engaged in for profit. Although ordinary and necessary business expenses may include entertainment expenses, the deductibility of business entertainment expenses is subject to a number of separate and additional requirements.

Business meals are deductible if they occur under circumstances that are "conducive to a business discussion." There is no requirement that business actually be discussed, either before, during, or after the meal. Expenses for other entertainment activities are deductible only if they are "directly related to" or "associated with" the taxpayer's trade or business. Entertainment activities are considered "directly related" if the taxpayer has more than a general expectation of deriving income or a specific trade or business benefit (other than goodwill) from the activity. The taxpayer need not show that income actually resulted from the entertainment. In general, entertainment expenses satisfy the "associated with" standard if they are directly preceded or followed by a substantial and bona fide business discussion. A business discussion may be considered substantial and bona fide even if it consumes less time than the associated entertainment and does not occur on the same day as the entertainment activity.

Entertainment facilities, such as yachts, hunting lodges, or country clubs, used to entertain clients or customers are also subject to separate rules. A deduction is allowed for the portion of the cost of club memberships that are "directly related" to the taxpayer's business if the facilities are used primarily for business purposes. No deduction is allowed for other types of entertainment facilities. Tickets to sporting and theatrical events, and the costs of skyboxes, lounges, boxes or other similar arrangements that provide the taxpayer a specific viewing area to a sporting or theatrical event are not, however, considered to be expenses related to an entertainment facility. Thus, such expenses are fully deductible if they meet the "directly related to" or "associated with" tests for entertainment activities.

Entertainment expenses also are subject to separate substantiation requirements. Deductions for entertainment expenses must be supported by records showing the amount of the expense, time and place of entertainment, business purpose of the expense, and business relationship to the taxpayer of any persons entertained.

Reasons for Change

In General. The special requirements for deductibility of business entertainment expenses have been the subject of repeated Congressional concern since their enactment in 1962. The existing requirements are an attempt to provide taxpayers and the Internal Revenue Service with standards for deductibility. Current standards, however, are predominantly subjective, leaving application of the law uncertain and creating significant opportunities for abuse. Under present law, the costs of country club memberships, football and theater tickets, parties, and lunches and dinners at expensive restaurants are all deductible, if a plausible business connection can be demonstrated. The existing tests for whether a business connection exists are premised upon the taxpayer's expectations and intentions, and thus may result in a deduction being allowed in cases where less time was devoted to business than to entertainment, no business was discussed, or the taxpayer was not even present at the entertainment activity.

The liberality of the law in this area is in sharp contrast to the treatment of other kinds of expenses that provide both business and personal benefits. In some cases, such as work-related clothing, the presence of any personal benefit is deemed sufficient reason to disallow any deduction. In other cases, taxpayers are allowed to deduct only the proportion of expenses allocated to business. In contrast, present law often allows full deductibility of certain entertainment expenses even though the connection between the entertainment expense and business activity is extremely tenuous.

Efficiency. The treatment of "business related" entertainment under current law encourages excessive spending on entertainment. The business person in a 40 percent marginal tax bracket considering whether to order a $20 or a $30 "business meal" knows that the more expensive dinner, though its price is $10 higher, will only cost $6 more because of the available deduction. The taxpayer's choice of meals is much more likely to be based on personal rather than business considerations, but the deductibility of the expense makes selection of the expensive meal more likely than in a nonbusiness context. Similarly, a business person in the 50 percent marginal tax bracket may conclude that it costs nothing extra to take a business associate to the theater even if it serves little or no business purpose. The attendance of the business associate permits a claim that the cost of both tickets are deductible, and thus an extra ticket costs nothing on an after-tax basis.

Present law has no effective response to these practices because it attempts to separate personal from business entertainment expenses on the basis of the taxpayer's intentions and purposes. It is frequently possible to demonstrate an actual business purpose or connection for an entertainment expense that nevertheless has a strong, if not predominant, element of personal consumption. The problem is exacerbated by the fact that no objective standards exist for determining whether an expense is based upon the personal or business benefits derived. The use of the subjective terms "directly related" and "associated with" leads to liberal interpretations by taxpayers, who cannot reasonably be expected to deny themselves the benefit of any doubt. Moreover, as an administrative matter, entertainment expense deductions are often difficult to audit. The cost of giving a party for friends who are also business associates is often allowed even if the primary motive for the party was personal enjoyment, not business benefit.

Fairness. The current treatment of business entertainment expenses encourages taxpayers to indulge personal entertainment desires while at work or in the company of business associates. The majority of taxpayers, however, do not benefit from this incentive. Most hold jobs that do not permit business entertainment, and many others are scrupulous in claiming business deductions for personal entertainment.

Current law thus creates a preference for the limited class of taxpayers willing and able to satisfy personal entertainment desires in a setting with at least some business trappings. Lunches are deductible for a business person who eats with clients at an elegant restaurant, but not for a plumber who eats with other workers at the construction site. A party for friends of a business person is deductible if they are business associates, but a party for friends of a secretary, sales clerk, or nurse is not deductible.

Extreme abuses of these deductions are frequently cited by those who assail the tax system as unfair. Abuses, even if rare, seriously undermine the integrity of the tax system and undercut the public trust that is essential to it. Some limitation on the deductibility of entertainment expenses is necessary if such perceptions of unfairness are to be eliminated.

Proposal

No deduction would be allowed for entertainment expenses, except for certain business meals. A deduction would be allowed for ordinary and necessary business meals furnished in a clear business setting (as defined in Treasury regulations). For each person participating in each business meal, this deduction would be limited to $10 for breakfast, $15 for lunch, and $25 for dinner. The meal cost limitations would include gratuities and tax with respect to the meal.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986, except that a deduction would be allowed for 50 percent of ordinary and necessary business meals expense (in excess of meal limit) incurred in taxable years beginning on or before January 1, 1987.

Analysis

Business Meal Limitations. Business meals provide a mixture of business and personal benefits. The extent to which a meal provides a personal benefit will vary, and it is not possible to develop rules that would specify the precise percentage of personal benefit in specific cases. The proposal, therefore, provides objective limitations that are intentionally quite generous, yet are intended to deny deductions for that portion of meal costs which is most likely to constitute personal rather than business benefit. Expenses in excess of the limitation are deemed to be incurred for personal rather than business reasons. The deduction will be disallowed only for the amount above the stated limit.

Representatives of the restaurant industry in testimony before Congress have provided several estimates of the average cost of restaurant meals. If adjusted for inflation, those estimates would range between $6.50 and $10.00 for 1983. In addition, Census data shows that only about 2.5 percent of all restaurant meals in 1977 were in restaurants where the average bill exceeded $10.00. Adjusted for inflation, this suggests that only about 2.5 percent of all meals were in restaurants with average bills over $17.00 in 1983.

While the proposal will reduce the number of expensive business meals, it is expected that the limitations will not have a significant impact on more than five percent of restaurants. Moreover, since some high-cost meals will be replaced by moderate-cost meals, the effect on total employment in the restaurant industry is expected to be modest.

Businesses are currently required to keep detailed records for all deductible meals. Therefore, the additional recordkeeping costs should be minimal.

Placing ceilings on the deductibility of business meals would eliminate the extreme cases of abuse -- those that affect the average taxpayer the most. Despite its small revenue effect, the proposal would be of significant assistance in restoring trust in the tax system.

The Elimination of Other Entertainment Deductions. The proposal would completely eliminate deductions for entertainment expenses such as tickets to professional sporting events, tickets to the theater, the costs of fishing trips, and country club dues. Because all such entertainment has a large personal component, the proper tax treatment, on both efficiency and equity grounds, is to disallow a deduction.

Approximately one-third of all baseball tickets and over one-half of all hockey tickets are purchased by businesses. The net effect is often to raise the cost of tickets for those who are not subsidized through the tax system for their purchases. Some performing arts organizations also sell large proportions of their tickets to businesses. Some tickets bought by businesses would remain deductible as gifts to their employees, but only if individual gifts are valued at less than $25.

If a public subsidy of such entertainment is desirable, a direct expenditure program could better target the aid. Further, current law raises serious equity questions by increasing the demand for tickets thereby causing the price of tickets to rise for the general public.

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LIMIT DEDUCTION FOR TRAVEL EXPENSES

General Explanation

Chapter 3.23

Current Law

Travel expenses incurred by a taxpayer while "away from home" are deductible if such expenses are reasonable and necessary in the taxpayer's business and are directly attributable to the taxpayer's business. Travel expenses may include the cost of travel to and from the destination and the cost of meals, lodging, and other incidental travel costs (e.g., laundry, taxi fares) incurred while at the business destination. A taxpayer's "home" for purposes of the deduction is generally his or her business headquarters. A taxpayer is considered to be "away" from his or her business headquarters only if the travel involves a "temporary" rather than an "indefinite" assignment at another location. If a taxpayer accepts a job at a distant location for an indefinite period, the new job location becomes the taxpayer's tax home. Temporary employment generally is expected to last for a short or foreseeable period of time, but whether employment is temporary or indefinite is essentially a factual question.

The cost of commuting to and from a taxpayer's business headquarters is not considered business travel. Commuting costs generally are considered to relate to an individual's personal choice of his or her place of residence rather than to business necessity and are not deductible. An exception to the commuting rule has sometimes been made for taxpayers, such as construction workers, who are employed on a temporary basis at one or more job sites beyond the metropolitan area where they reside.

The costs of attending a convention or other meeting (including the costs of meals and lodging) in the North American area are deductible if the taxpayer is able to show that attendance at the convention is directly related to his or her trade or business and that such attendance is advancing the interests of the taxpayer's trade or business. The North American area includes the United States, the U.S. possessions, the Trust Territory of the Pacific Islands, Canada, Mexico, and certain Caribbean countries that have entered into exchange of tax information agreements with the United States. A stricter rule applies for conventions held outside the North American area. In order to claim a deduction for the costs of attending such a convention, a taxpayer must also show that it was "as reasonable" for the meeting to be held outside the North American area as within it.

Deductions for conventions, seminars, or other meetings held on cruise ships are subject to additional limitations. No deduction is allowed unless the cruise ship is registered in the United States and only at ports of call in the United States or in possessions of the United States. In any event, a taxpayer may deduct no more than $2,000 for such meetings per year.

Professional education expenses, including travel as a form of education, are deductible if the education maintains or improves existing employment skills or is required by an employer, or applicable law or regulation. To be deductible, the travel must be directly related to the duties of the taxpayer in his or her employment or other trade or business. The deductible educational travel may occur while the taxpayer is on sabbatical leave.

Reasons for Change

The present limitations on deductions for business travel fail to establish reasonable distinctions between costs incurred for business purposes and costs reflecting personal consumption. The deduction for expenses for meals and lodging incurred "away from home" is premised on the assumption that the business traveler incurs additional costs while away from home. Restaurant meals are likely to be more expensive than the cost to the taxpayer of eating at home, and hotel accomodations are a duplicative expense for the taxpayer who maintains regular living quarters elsewhere. These excess costs incurred by a taxpayer away from home are, at least in part, legitimate business expenses.

Current law, however, does not limit the deduction for away from home meals and lodging to the portion of the cost that represents an extra or duplicate expense. The full deductiblility of such travel expenses permits a taxpayer who is away from home to deduct some costs that would be incurred even if he had stayed at home. For example, a taxpayer may deduct the full cost of meals even though some costs for meals would have been incurred if the taxpayer were not away from home. Moreover, the full deductibility of business travel expenses encourages excessive spending. For example, an additional $30 for more expensive accomodations will cost a business traveler only $18 if he or she is in the 40 percent marginal tax bracket and, as is likely under current standards, can establish that such accomodations are an ordinary and necessary expense.

The liberality of current law is greatest for taxpayers who remain away from home in a single city for an extended period of time. Extended travel status permits the taxpayer to take advantage of certain economies not available on shorter trips. For example, a professor visiting another university for a year probably will spend the same amount for lunch or dinner as he or she would have spent at home. Similarly, a taxpayer on extended travel at a single location ordinarily will be able to reduce the incidental costs of travel, such as laundry or transportation to the office.

In addition, the current tax treatment of trips that combine business travel with a vacation create opportunities for abuse. Many travel and business publications feature articles and promotional material that explain how taxpayers can pay for vacations with tax deductible dollars. These abuses distort business decisions and reduce the efficiency of the economy. For example, a taxpayer may alter the place and timing of business meetings for no reason other than to coincide with vacation plans. The current rules are also unfair. Some individuals are able to take deductions for personal expenses simply because they are better informed about the law. The presence of such obvious abuses undercut taxpayer trust in the integrity of the tax system.

The current deduction for travel as a form of education creates an even greater opportunity for abuse. Availability of the deduction is premised solely on the taxpayer's intent and expectation in making the trip. Accurate administrative review of such expenses is impossible due to the lack of objective standards.

Proposals

1. Deductions for meals, lodging, and incidental travel expenses incurred by a taxpayer while located in one city away from home for 30 days or less would be limited to 200 percent of the maximum Federal reimbursement rate per day for that city, as published in the Federal Property Management Regulations, 101-7, G.S.A. Bulletin F.P.M.R. A-40. For example, the current applicable limit for a taxpayer located in Baltimore, Maryland for 30 days or less would be $150 per day. Deductions for expenses for meals and lodging incurred by a taxpayer while located in one city away from home for more than 30 days would be limited to 150 percent of the Federal per diem rate for that city. No deduction would be allowed for incidental travel expenses (e.g., lanudry, taxi fares) incurred by a taxpayer while located in one city away from home for more than 30 days. For purposes of determining whether a taxpayer is away from home, travel assignments which extend for more than one year in one city would be considered indefinite, and travel deductions be allowed.

2. A deduction for the daily transportation expenses of taxpayers (such as construction workers) who have no regular place of work and must travel at least 35 miles (one way) to job assignments that last less than one year would be allowed for the commuting expenses incurred for mileage in excess of 35 miles (one way).

3. For purposes of determining whether a taxpayer is away from home, travel assignments which extend for more than one year in one city would be considered indefinite, and no travel deductions would be allowed.

4. Employee business travel expenses that are not reimbursed by a taxpayer's employer under a reimbursement or other expense allowance arrangement would be deductible to the extent such expenses, together with miscellaneous itemized deductions, exceed one percent of the employee's adjusted gross income. For a discussion of the one percent floor on the deductibility of the such expenses, see Chapter 4.03.

5. No deduction would be allowed for business travel by ocean liner, cruise ship, or other form of luxury water transportation in excess of the cost of otherwise available business transportation unless the taxpayer provides proof of existing medical reasons for utilizing such transportation.

6. No deduction would be allowed for conventions, seminars, or other meetings held aboard cruise ships.

7. No deduction would be allowed for travel as a form of education.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposed limitations on travel expense deductions are designed to provide reasonable boundaries and eliminate the most extreme cases of abuse without unduly restricting deductions for legitimate business expenses. The dollar limitations are intentionally quite generous and are intended to deny deductions for that portion of travel expenses that is most likely to constitute personal satisfaction rather than business convenience. Expenditures in excess of the applicable limitation are deemed to represent luxury accomodations and meal costs incurred for personal rather than business reasons. The lower limits for trips lasting longer than 30 days reflect the economies that are available during extended periods of travel; the disallowance of incidental expenses after 30 days in one city recognizes the significant personal component of such expenses.

The proposed treatment for taxpayers, such as construction workers, who have no regular place of work addresses an area of the law that is a continuing source of litigation and confusion. Although commuting expenses to and from a regular place of work are nondeductible without regard to the length of the commute, it is reasonable to permit a deduction for transportation expenses to a nonregular place of work, such as a construction site, where the taxpayer is employed for a temporary period. Commuting expenses generally are disallowed on the theory that where a taxpayer chooses to reside -- whether near or far from the workplace -- is a matter of personal choice. That rationale is inappropriate when a taxpayer's workplace is constantly shifting, the jobs are temporary in nature, and the taxpayer must travel long distances to reach the job site.

The special commuting deduction would be allowed only for transportation expenses in excess of 35 miles (one way), would not extend to meal costs, and would be available only for job assignments that last less than one year. By using an objective mileage standard rather than requiring that travel be outside the "metropolitan area," the proposal would eliminate uncertainty and create uniformity among taxpayers located in different parts of the country.

The one-year rule for defining temporary employment would eliminate a significant source of dispute between taxpayers and the Internal Revenue Service, and would provide a reasonable division between temporary and indefinite assignments. One year is sufficient time for regular living patterns to be established at the new location and, thus, food and lodging expenses would no longer need to be duplicative or more expensive than comparable costs at the original job site.

The disallowance of a deduction for the cost of travel by cruise ships, ocean liner, or other form of luxury water transportation in excess of the cost of otherwise available business transportation is intended to deny a deduction for the portion of the travel cost most likely to constitute personal rather than business benefit.